Economic & Investment Update - April 2018

Despite the global economy continuing to grow robustly, with promising GDP figures from developed and emerging economies, fears that inflationary pressures would push the US Federal Reserve into tightening monetary policy faster than expected and threats of a trade war between the US and China led to heightened volatility in global markets.

In the US, economic data remained broadly positive as US business confidence reached an unexpected high in March, GDP for Q4 2017 was revised upwards (to 2.9%) and industrial activity continued to expand. Equities were initially buoyed by the ongoing strength in economic data, robust earnings and the approval of a major tax reform package.

However, the latter part of the quarter saw a marked increase in volatility and a sell-off in global markets. Investors first digested the destabilising potential of an elevated US inflation reading and the possibility that the US Federal Reserve would need to become more aggressive in raising interest rates to keep upward price pressures under control. While US interest rates were increased by 25 basis points in March, the Fed advised that it did not alter its overall rate projection of three increases for 2018. This quelled some concerns, but escalating US-China trade sanctions precipitated a renewed bout of turbulence in March.

In Europe, the economic backdrop remained encouraging with GDP growth for Q4 2017 confirmed at 0.6% and unemployment stable at 8.6%. Annual inflation was 1.1% in February, below the European Central Bank's (ECB) target, with ECB chairman Mario Draghi reiterating that interest rates would not rise until well past the end of the quantitative easing programme. On the political front, the key event was Italy's election, which yielded no overall winner while Germany formed a new government after its inconclusive elections in September 2017.

In China, economic data remained broadly stable, albeit there were signs of a gradual slowing in momentum. The Japanese economy also experienced a slightly soft patch for economic growth in Q1 2018 with many indicators of production and consumption slipping slightly. However, Japan's longer-term trend of economic improvement appeared intact.

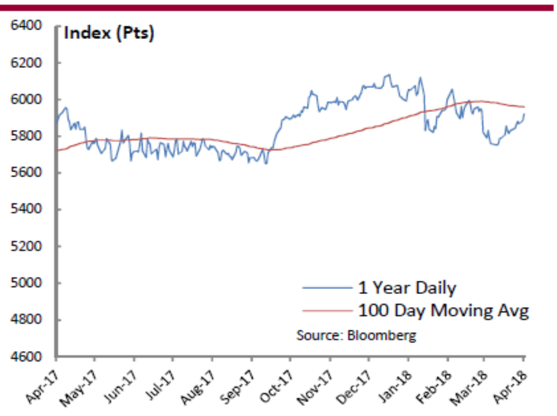
On the domestic front, the Reserve Bank of Australia (RBA) kept rates on hold at 1.5% throughout the March quarter (unchanged now for over a year). While employment growth was strong (3.5% annual growth), lacklustre wages growth and below-target inflation allowed the RBA to maintain its cautious monetary policy stance.

MARKETS

The Australian Equity market produced its worst March quarter performance since the GFC, with the S&P/ASX 200 Accumulation Index falling by 3.7%.

While most sectors finished in the red for the quarter, the Telecommunications (-11.3%) and Financial (-5.9%) sectors generated the lowest returns. The poor performance within Telecommunications was largely driven by Telstra's struggles, which fell 12% for the quarter as its core earnings remained under strong pressure. Financials were also under pressure, as the Royal Commission's focus on potential irresponsible mortgage lending practices hit banks with significant mortgage books the hardest.

ASX200



Healthcare was the best performing sector, up 6.6% for the March quarter as the return of volatility in the market led to heightened demand for the defensive attributes of healthcare stocks. The sector also rallied off the back of strong earnings results for CSL and Resmed.

Small cap stocks continued to outperform large cap stocks during the March quarter with the Small Ordinaries Index 2.8% lower for the quarter. The recent strong performance of small caps is shown clearly in the rolling 12-month return, with small caps returning 15% and the S&P/ASX 200 returning only 3.7%.

Internationally, global stocks finished lower for the March quarter with the MSCI World ex-Australia Index returning -2.3%. However, with the Australian Dollar weakening against most currencies (-1.7% against the US Dollar), this provided some cushioning to Australian investors and global equities finished up 0.8% for the quarter in Australian Dollar terms.

The best performing market for the quarter was Hong Kong (up 0.6% as measured by the Hong Kong Hang Seng Index) while European and Japanese markets produced the lowest returns (down between 5 and 8%). Emerging markets performed well, returning 3.4% for the quarter.

Listed property suffered a poor start to the 2018 calendar year with domestic property down 6.4% and global property down 5.3% for the March quarter. Market concerns about the inflationary outlook in the US and the likely impact on bond yields led to weakness with this sector. Global Infrastructure was also lower, down 5.8% for the quarter.

Australian bonds (Australian composite index) produced a modest return of 0.9% for the quarter with similar returns across Government Bonds and credit as bond yields rose. The global composite bond index produced a small negative return of -0.1 as bond yields rose and credit spreads widened.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	S&P/ASX 200 TR (Accumulation) Index	-3.7	3.7	7.9
	S&P/ASX Small Ordinaries TR (Accum) Index	-2.8	15.0	6.5
International	MSCI World ex Aust NR Index (AUD)	0.8	13.3	17.0
	MSCI World ex Aust NR Index (AUD Hedged)	-2.3	11.0	12.6
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	3.4	24.3	11.6
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	-6.4	-0.8	10.6
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	-5.3	1.2	6.9
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	2.4	12.9	11.7
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	-5.8	1.5	10.0
Currencies				
AUD v USD	Against US Dollar	-1.7	0.7	-5.9
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	0.9	3.3	4.3
	Bloomberg Ausbond Credit All Maturities	0.8	4.2	4.8
International	Bloomberg Barclays Capital Global Agg TR Index (AUD Hedged)	-0.1	2.9	4.7
Commodities				
Gold	Gold – USD	1.7	6.1	-3.7
Oil	WTI Oil $/b – USD	7.5	28.3	-7.8

Economic & Investment Outlook

While the overall global economic environment continues to be relatively buoyant, with key economic indicators such as unemployment, GDP and manufacturing growth all positive, the threat of rising interest rates in the US remains the most likely source of a setback for the economic outlook and for investment markets.

In the US, inflationary pressures from recent corporate tax cuts and the need for a significant increase in the issue of government bonds to fund the associated budget deficit could lead to increases in both long and short-term interest rates. The prospect of increased protectionism also continues to cause concern however, it is difficult to ascertain whether this is a genuine long term economic strategy by the US or simply part of President Trump's shorter-term rhetoric. Historically, protectionist policies have had an adverse effect on economic growth.

In Europe, forward-looking surveys paint a picture of slower future growth, after a surge in 2017, with the strengthening Euro slowing the rate of growth in exports. However, as part of its continued support, the ECB recently committed to its £30 billion monthly bond-buying program, until at least September. There are expectations that growth will stabilise at a solid pace and that inflation would converge towards its aim of around 2% over the medium term.

In China, slower growth is likely in the months ahead as the drags on economic activity from weaker credit growth and the cooling property market intensify. Economists expect China's economic growth to ease to 6.5% this year, with a regulatory crackdown on the country's finance sector and the trade dispute with the US seen as key risks.

In Australia, given the concern of policy makers over the impact of interest rate rises on the household sector, especially given current low wages growth and high levels of household debt, the RBA seems certain to roll over its 'no change' policy position through the rest of 2018. RBA rhetoric continues to suggest the next move is up, but it will prefer to wait until the household sector is better positioned before embarking on the policy normalisation process.

With the May 2018-19 Budget approaching, the focus is now turning to fiscal policy. Reflecting the strength in global growth and commodity prices, as well as the significant gains in employment and improved corporate profits, there has been a sharp improvement in the government's fiscal position. With an earlier return to surplus now possible and an election looming, the government will likely announce personal income tax cuts with the objective of boosting spending and confidence in the lead up to the next election.

Australian Shares

We recommend investors continue to hold a neutral to underweight position in Australian Equities, relative to their benchmark allocation.

We believe that we are in a market of relatively low returns, given that there seems little scope for valuation re-rating and that Australian corporate earnings, in aggregate, are running at around mid-to-low single digits. This, in combination with significant challenges to long-established business models and industry structures, provides a challenging back drop for the market.

While small cap stocks have significantly outperformed larger companies over the last 12 months, valuations remain relatively expensive.

Global Shares

We recommend that investors hold a neutral to overweight holding in International Equities with a bias away from the US towards European and Emerging Markets.

Asset valuations remain at elevated levels with the US market looking the most expensive based on traditional valuation measures such as P/E ratios and book-to-price metrics, however valuation in certain sectors and stocks have been supported by strong earnings. As previously noted, improving economies, continued monetary stimulus and more attractive stock valuations, provide better value for investors in European stocks.

Similarly, despite the change in focus away from a strict growth target, we expect stock market rises to continue in China as strong economic growth continues.

Property

Australian listed property is currently trading at around a 10% discount to Net Asset Value (against a long-term average of a 5% discount), an annualised dividend yield of around 5.5% with sector gearing at 29%. However, following losses in the March quarter, we are mindful that a further rise in long term bond yields could lead to further falls in the value of property holdings.

We therefore suggest that investors hold a neutral to underweight position to domestic property relative to their benchmark allocation. From a sector perspective, while office and industrial sectors are expected to continue to perform well, underpinned by low vacancy levels, the retail sector may underperform. As part of a diversified portfolio, we also continue to suggest that investors consider alternative unlisted options in selected property sectors, where available.

In relation to global property, we suggest an underweight to neutral holding relative to benchmark allocations due to the sensitivity of global property to rising bond yields.

Fixed Interest

Bond markets produced mixed returns over the quarter as a result of the rise in bond yields and the widening of credit spreads. With the likelihood of interest rate rises increasing, we recommend that investors hold an underweight position to both Australian and International Government Bonds. However, further rises in bond yield may provide opportunities to reallocate to this sector during the 2018 calendar year.

Within credit markets, despite the recent widening of credit spreads, the sector remains expensive. As with our view on Government bonds, we continue to recommend an underweight position with a preference for Australian corporate debt and hybrid securities.

Sources: Lonsec, Schroder